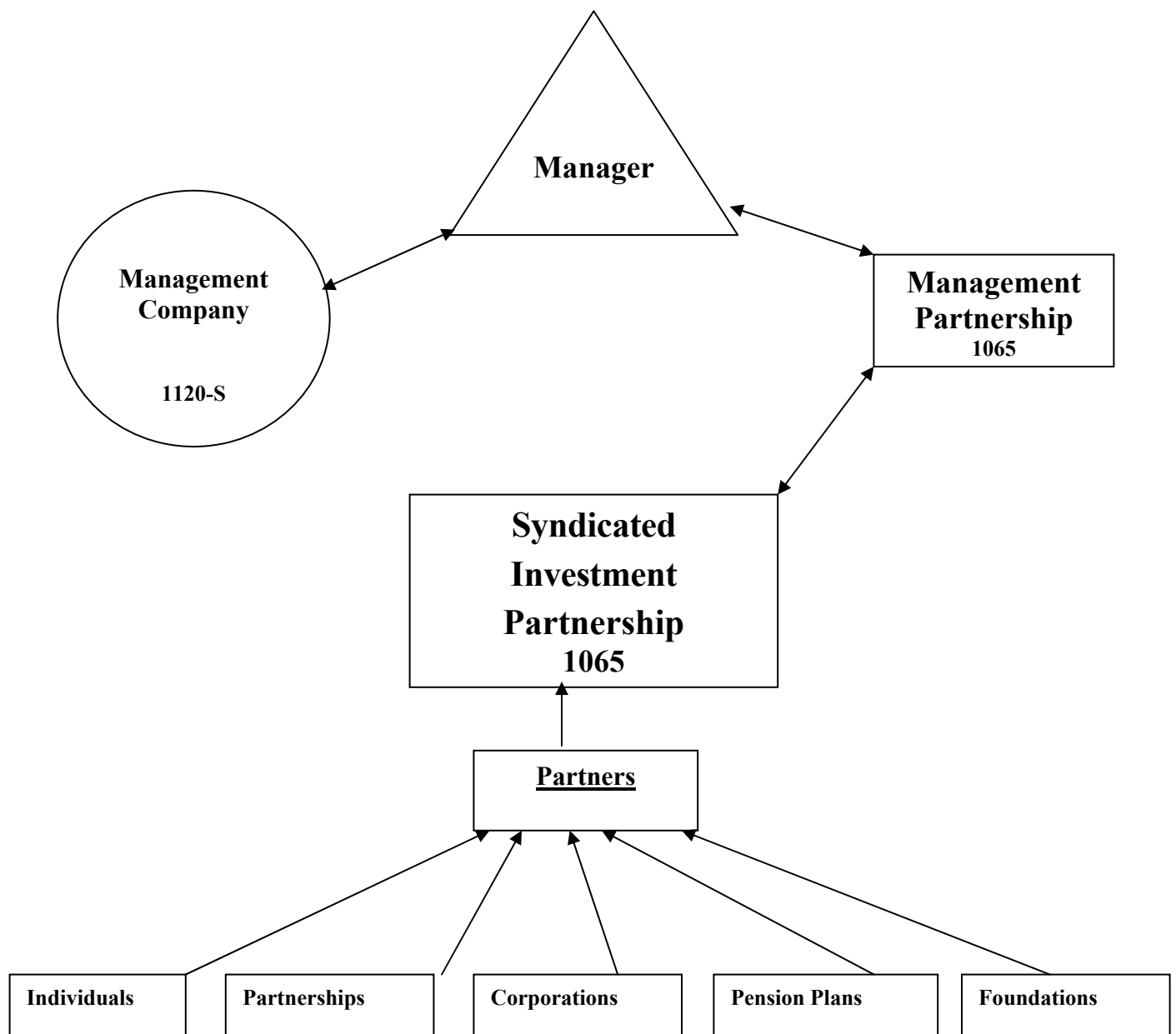


Syndicated Investment Partnerships

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OVERVIEW

Syndicated Investment Partnerships as used in this guide are pools or syndicates formed, marketed, and managed by professional money managers. Since minimum investments start at \$50,000 and it is not unusual for them to be higher than \$500,000, the investor partners are generally wealthy individuals or families. Foundations and other tax-exempt organizations are also frequently investors.

Investment partnerships invest in stocks and bonds, both domestic and foreign, but sometimes concentrate on more exotic securities such as options, futures, forward contracts and other derivatives. Foreign currencies and related instruments are used and many are involved in arbitrage and straddles.

The partnership agreements generally provide that contributions and distributions can only be made as of year-end, although some funds provide quarterly valuations.

ORGANIZATION AND OPERATIONS

The most common type of organization involves an Investment Partnership

where investments are made, the Managing Partner which is frequently a partnership composed of the Manager, Key Employees, family members, and the Management Company as illustrated in Exhibit 12-1.

The partnership agreement provides that the Investment Partnership shall pay a fee of 1 percent of assets to the Management Company for administrative expenses. In addition, the partnership pays an incentive fee to the Managing Partner that is generally 20 percent of net profits determined on the accrual basis using mark-to-market. (For Mark-to-Market, unrealized gains and losses are booked by adjusting the value of securities to FMV at year-end.) In the event of a loss, that amount is carried over and reduces profits in the next year for the purpose of determining the incentive fee.

Generally partners are admitted, and existing partners may make additional contributions or take distributions, only as of the first of the year. For example, a new partner would submit his or her cash contribution in December in order to be admitted as a partner as of January 1 of the following year; the percentage interest they acquired is not determined until after the books are closed and net income for the year is computed. If the partner redeems his or her interest, the effective date is December 31, but he or she will probably not receive the proceeds until late January or early February of the following year when the actual amount of the capital account is determined. The partner will get a final Schedule K-1 for the year and report gain or loss on disposition in the next year, the year in which he or she received the cash proceeds from the disposition of his or her partnership interest.

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ISSUE: SECURITIES TRADERS- ENGAGED IN A TRADE OR BUSINESS?

Since Investment Partnerships engage in substantial buying and selling of intangible assets, some partnerships claim that their activity constitutes "securities trading" such that they are engaged in a trade or business and not "investing." The distinctions between a "trader" and an "investor" for tax purposes are very significant and arose more than 50 years ago as a result of the Supreme Court decision in **Higgins v. Commissioner**, 61 S Ct. 475 (1941). There the Court stated that **"No matter how large the estate or how continuous or extended the work required may be, managerial attention to your own investments does not constitute a trade or business."**

At the time of **Higgins**, only trade or business deductions were deductible and as a result taxpayers were denied **any** tax benefit for investment expenses. Congress considered that it was inequitable to deny any deduction for expenses that might increase taxable income, but were not willing to provide the same beneficial treatment as trade or business expenses. The result was the enactment of the predecessor to IRC section 212, which provided an itemized deduction for expenses incurred for the production or collection of income, or for the management, conservation or maintenance of property held for the production of income. The enactment of IRC section 67 in 1986, combined with changes in the computation of Alternative Minimum Tax, made these deductions much less attractive to investors. The higher your income, the less attractive they are.

By claiming to be engaged in a trade or business, the Investment Partnership is entitled to claim their expenses as "Other Deductions" on Schedule K. (Some partnerships claim all expenses as Other Deductions on page 1 of Form 1065. This results in a large ordinary loss on line 1 of Schedule K since none of the income is on page 1.)

Prior court cases have held that traders on the floor of the Commodity Futures Trading Commission are entitled to capital gain or loss treatment on their trades. The courts reasoned that since the traders were required to buy and

sell at "open outcry," the futures were not held for sale to customers in the ordinary course of business; that is, without the ability to "mark up" futures, they did not meet the definition of inventory and, therefore, must be treated as capital assets.

Although the floor traders had only capital gain or loss and no ordinary business income, the courts have consistently found that their activity rises to the level of a trade or business. As a result, floor traders file Schedules C with only their expenses; all their income is on Schedule D. Congress has endorsed this treatment by enacting special legislation for these traders to provide them with Social Security coverage, special capital loss carrybacks, and pension plan deductions.

What Is a Securities Trader?

"Although the Supreme Court has yet to find a taxpayer properly characterized as a 'securities trader,' it is clear that such a 'businessman' exists, given the proper facts." (**Levin v. United States**, 79-1 U.S.T.C. 9331) The standard applied by the lower courts to distinguish between an investor and a trader was first enunciated by the Tax Court in **Liang v. Commissioner** (23 T.C. 1040): "In the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis. There is general agreement amongst the courts (**Moeller v. United States**, 83-2 U.S.T.C. 9698 and **Purvis v. Commissioner**, 76-1 U.S.T.C. 9270) that the following factors are to be considered in determining whether a taxpayer is an investor or engaged in the trade or business of securities trading:

1. The taxpayer's intent- investment negates trader status.
2. Nature of the income from the activity- only short term gains qualify as trading income.
3. Frequency, extent and regularity of transaction- holding period can be critical.

Items 2 and 3 are objective (and quantitative) indicators of intent which are principally relied on. Taxpayers who mention "capital appreciation" or even "conservation of capital" do not prevail. Significant long term capital gains, and even dividends and interest, are strong indications of an investor and not a trader.

In one instance, the Court of Claims (**Mayer v. United States**, 94-2 U.S.T.C. 50,509) took the position that a taxpayer who carefully selected money managers and farmed out a portion of his funds to each could not be considered a securities trader since he did not actually make any purchase or sale decisions himself; "To claim a trade or business deduction, taxpayer must himself perform the activity characterizing the 'trade or business' citing **Groetzinger** (87-1 U.S.T.C. 9191). The Tax Court considered the same taxpayer for subsequent years and came to the same result based on holding period and frequency of trading. (**Mayer v. Commissioner**, TCM 1994-209)

The Supreme Court provided in **Higgins** that expenses related to real estate rental were deductible and that office and salary expenses could reasonably be allocated between investment and trade or business. Accordingly, even where it has been determined that a partnership is engaged in the trade or business of securities trading, care must be taken to ensure that any portion of the partnership's activity or expenses that are properly allocable to investment

should be separately stated.

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ISSUE: INVESTMENT INTEREST EXPENSE DEDUCTIBLE ON SCHEDULE E?

Syndicated Investment Partnerships invariably advise their partners to adhere to the limitations on Investment Interest. Where the partnership has taken the position that they are engaged in the trade or business of securities trading, the partnership will advise the partners to claim the deductible portion of the interest expense on Schedule E. As explained below, this is not correct.

All investors in syndicated investment partnerships are limited partners since they do not wish to place their entire net worth at-risk. IRC section 163(d)(5)(A)(ii) provides that "property held for investment" includes any interest held by a taxpayer in an activity involving the conduct of a trade or business that is not a passive activity and with respect to which the taxpayer does not materially participate. Treas. Reg. section 1.469-1T(e)(6) provides that securities trading is not a passive activity, regardless of whether it rises to the level of a trade or business. Thus, the interest expense is deductible only to the extent permitted by IRC section 163(d).

Since the treatment of non-corporate partners is dependent on the degree of participation of such partners, IRC section 163(d) could limit the deductibility of the interest expense associated with the partnership's trading activity for some partners and not others. Treas. Reg. section 1.702-1(a)(8)(ii) requires that each partner must take into account separately his or her distributive share of any partnership items that, if taken into account, would result in an income tax liability for that partner different from that which would otherwise result. This is why the partnerships are not permitted to deduct interest expense on page 1 of Form 1065 in computing ordinary net income. In addition, a partnership engaged in the trade or business of securities trading may not treat portfolio interest expense allocated from another partnership as a trade or business expense, since the character of the item is determined at the partnership level.

NOTE: Although the instructions for Investment Interest on Form 4952 provide that for "any portion (which) is attributable to a trade or business in which you did not materially participate and that is not a passive activity, enter that part of the interest expense on the schedule where you report other expenses for that trade or business," there does not appear to be any statutory authority for that position.

Examination Techniques

The starting point for an examination of a Syndicated Investment Partnership is to obtain a copy of the "Offering Memorandum" which is required by the Securities Exchange Commission to be provided to investors. This document should contain a complete description of the management fees, objectives, the principals and other useful information. A discussion of the tax treatments and risks is usually included. A copy of the original Partnership Agreement will be included as an exhibit, but the examiner should request copies of any Amendments.

Where the partnership reports little long-term capital gain, or where it is attributable entirely to IRC section 1256 straddles, trade or business is not likely to be an issue. In determining whether the partnership is engaged in the trade or business of securities trading, the Investment Objectives portion of the Offering is of paramount importance. Objectives other than taking advantage of short-term market movements negate securities trader status.

Where the managing partner is a flow-through entity, request a copy of the

return. The managing partner is performing personal services, although the income received may be characterized as interest, dividends, and capital gains. If family members or trusts have an interest in the managing entity, see FAMILY PARTNERSHIPS above to ensure that proper allowance has been made for personal services performed.

Issue Identification

Does the partnership claim long-term capital gains and expenses deducted as business expenses, either on page 1 or as "Other Deductions" on line 11 of Schedule K?

Is there a substantial amount of interest expense? Is it separately stated as Investment Interest Expense on line 14a of Schedule K?

Is profit and loss allocated based on something other than capital; that is, are the profit and loss ratios on the Schedules K-1 different than the capital percentage? This indicates that the managing partner gets a special allocation of profits for services. Is this income allocated only to those performing services?

Documents to Request

1. Offering Memorandum or Private Placement Memorandum
2. Partnership Agreement and any Amendments thereto ("Articles of Organization" in the case of LLCs)
3. Copies of manager's return if the managing partner is a flow-through entity
4. Sample correspondence provided to partners with their Schedules K-1
5. A calculation of partnership tax basis if the partnership is using accrual/mark-to-market for book and cash for tax.

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Supporting Law

Higgins v. Commissioner 61 S.Ct. 475 (1941) • There the Court stated that **"No matter how large the estate or how continuous or extended the work required may be, managerial attention to your own investments does not constitute a trade or business."** In addition, the decision provides the basis for allocating expenses between investment and trade or business.

Levin v. United States, 79-1 U.S.T.C. 9331 • "Although the Supreme Court has yet to find a taxpayer properly characterized as a 'securities trader,' it is clear that such a 'businessman' exists, given the proper facts."

Liang v. Commissioner (23 T.C. 1040) • "(with an investor), securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis."

Mayer v. United States, 94-2 U.S.T.C. 50,509 • "To claim a trade or business deduction, taxpayer must himself perform the activity characterizing the 'trade or business' citing Groetzinger (87-1 U.S.T.C. 9191).

Exhibit 12-1 -Syndicated Investment Partnerships

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